USAID
FROM THE AMERICAN PEOPLE

EG Technical Briefings
Volume V No. 4, December 2008

Review of the Growth and Development Commission's "Growth Report" and its Prescriptions for Designing Workable Strategies to Achieve Sustained Economic Growth and Inclusive Development

Produced by an independent 21-member Commission on Growth and Development, *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, published by the World Bank in June of this year, focuses on the need for high, economic growth for inclusive development, and on how to design strategies that will achieve it. [1] This well written and fast paced book will enhance the reader's understanding of the growth process and economic policy's role in promoting it. Addressing a formidable list of policy issues, the report provides the current consensus view on many of them – providing a kind of "post Washington Consensus" consensus for the present decade.

The Commission draws on the experiences of a number of developing countries achieving sustained, high economic growth in the post World War II period, and on the large body of literature on economic growth and development. The Commission was led by Michael Spence, winner of the Nobel Prize in economics, and it is therefore often referred to as the Spence Report. Some see the Commission's consensus views on economic policy for stabilization and growth as replacing those of the Washington Consensus of the 1980s [2] This technical brief provides readers with a short condensation of the Report's principal points. The report in its entirety can be found on the World Bank's website using the following link:
http://www.growthcommission.org/index.php?option=com_content&task=view&id=96&Itemid=169 .

Lessons of Experience: The report starts out by looking at the experience of 13 countries having achieved sustained high rates of economic growth during the post World War II period : Botswana; Brazil; China, PRC; Hong Kong; Indonesia; Japan; Republic of Korea; Malaysia; Malta; Oman; Singapore; Taiwan, and Thailand. It notes that India and Vietnam, if their economic growth performance continues, may eventually be included in this select company of top performers. The 13 success story economies have all grown at an annual average of 7 percent or more for over 25 of the last 60 years. The report identifies distinctive growth related characteristics of these high-growth economies and asks how other countries can successfully emulate them.

Sustained growth via linking into an expanding world economy became possible for these 13 countries only because the world economy in the postwar period became progressively more open and integrated. They could and did take advantage of this opportunity to import ideas, technology, and know-how from the rest of the world; and exploit an increasing world demand providing a deep, elastic market for their goods far beyond that which existed within their borders.

The report then, in Part 2 "The Policy Ingredients of Growth Strategies," lays out what economic policies countries should follow to get and keep themselves on a high and steady economic growth path. To achieve sustained high rates of economic growth, economies should focus investment efforts in those areas with the highest incremental economic growth payoffs. Governments should avoid policies which by distorting prices send

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wrong signals. Setting investment priorities requires judgment. In fast-growing Asian countries, public investment in infrastructure accounts for at least 5-7 percent of GDP.   Public spending on education is justified on the grounds of efficiency and equality of opportunity. All sustained high growth economies have rapidly absorbed know-how, technology, and knowledge from the rest of the world. This is possible while respecting the natural concern to keep foreign investors from having undue political influence.

Barriers to entry and exit should be kept low, not raised to allow just one or a few firms to realize economies of scale within the national market. The economies of scale rationale advanced for raising barriers to entry is a weak one: dynamic productivity gains from competition easily can overwhelm gains from scale economies. The economy as a whole benefits from the rise and fall of industries. Openness to competition from outside is important. Structural change under competitive pressure spurs productivity growth. Promotion of specific industries or sectors through tax breaks, direct subsidies, import tariff exemptions, and/or cheap credit has had little growth payoff. But export processing zones have worked well in absorbing abundant labor.

Management of the exchange rate can be used for two purposes: a) to tip the balance slightly in favor of exports in early stages of growth, overcoming informational asymmetries; and b) to prevent surges of capital inflows from disrupting the profitability and growth of export sectors.   Use of the exchange rate for "industrial policy" is neutral as between industrial sectors, and does not make big demands on government discretion and expertise. This comes down to avoiding real appreciation of the exchange rate (see earlier technical briefs in this series on exchange rate policy).   A policy of avoiding real appreciation of the exchange rate may have some adverse side effects, however, such as limiting the amount of capital a country imports from overseas, foregoing the benefits of foreign direct investment (see earlier technical brief on FDI), and possibly reducing total investment.

There is general consensus on the benefits of financial openness in the long run. However, countries' reluctance to risk premature opening up of the capital account of the balance of payments is a legitimate concern. None of the 13 sustained, high-growth countries was particularly quick to open its capital account. There are no precise guidelines on how to open up an economy to the entry and exit of foreign capital and still minimizing the risk of financial crises. Thus, the report considers that countries should open up on capital account, removing capital controls, only in step with their financial market maturity. Opening up too fast introduces unnecessary risk of macroeconomic instability, but opening up too slowly can raise the cost of capital. However, openness and maturity have a two way relationship: the more open a financial system, the more mature it will become.

Stalling out at middle income levels: Out of the 13 high growth cases, six eventually reached the per capita income levels of advanced countries. But for some, economic growth seems to have slowed markedly at the middle-income level.   Whether this hurdle can be overcome or not remains to be seen. The reasons for this slowdown are complex and not well understood. The transition from middle-to-advanced-income levels deserves more attention. In countries whose economic growth has slowed in the middle-income range, inequality typically remains high and development does not proceed.

Factors beyond the individual country's power to influence, to which it must adjust itself: In a later chapter, "New Global Trends," the Growth Report discusses factors affecting a developing country's growth prospects that a country policymaker cannot hope to control, because they are aggregates of many countries' behavior, but which must be adjusted to. These include: (i) global warming; (ii) rising income inequality and sentiment for protectionism; (iii) the rise of China and India and the decline of internationally traded manufacturing goods' prices; (iv) the "adding-up" or as readers have usually heard it called, the "fallacy of composition" problem) in regard to export led growth (i.e. even though an export-led economic growth strategy can work for one country or a few countries, can it work if a large number of countries try it?); (v) rising prices of food and fuels; (vi) demographics, aging, and migration; and (vii) global imbalances and global governance. This technical brief recapitulates the discussion of three of them.

Rising Income Inequality and Protectionism: Income inequality is rising in a number of countries. This trend is a complex phenomenon with multiple causes: technological change, shifting relative prices and globalization. Partially as a result of this, skepticism about the benefits of globalization has mounted and protectionist sentiment is on the rise.

Rising Prices of Food and Fuel: (The report's publication antedated the recent tendency of commodity prices to retreat, giving up some of their gains). By the World Bank's estimate, some 100 million people may have been pushed into poverty because of the high commodity prices of 2007 – 2008. Low-income countries are particularly vulnerable. [4]

Global Imbalances and Problems of Global Governance: Major imbalances in trade and destabilizing developments in financial markets have emerged which threaten economic growth gains. The global economy indeed appears to many to have outrun policy makers' capacity to manage it. This creates risks for developing countries in particular because they are most vulnerable to sudden stoppages of credit, or shifts in changes of international demand and supply. In view of recent experience, developing countries are becoming skeptical of the proposition that lightly regulated capital markets work best.[5]

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ENDNOTES:

1. The term "Washington Consensus" was originally coined by economist John Williamson, to describe ten policy reforms combining trade liberalization with fiscal austerity in the 1980s in Latin America supported by the IMF and many aid donors, including USAID. See John Williamson's 1990 IIE publication "What Washington Means by Policy Reform," (chapter 2 in *Latin American Adjustment: How Much Has Happened?).* In response to Latin American dissatisfaction in the late 1990s with perceived results of implementation of "Washington Consensus" policy reforms, a task force was formed to identify more effective economic and social policies for

Latin America. This task force operated under the leadership of co-chairs Nancy Birdsall then with the Carnegie endowment and Augusto de la Torre, former director of Ecuador's central bank and member of the Carnegie Endowment Reform Network, producing the 2001 report, *Washington Contentious: Economic Policies for Social Equity in Latin America,* which provides ten tools for achieving social equity: 1) rule-based fiscal discipline; 2) smoothing booms and busts; 3) social safety nets that trigger automatically; 4) schools for the poor; 5) taxing the rich more and spending more on the rest; 6) giving small business a chance; 7) protecting workers' rights; 8) dealing openly with discrimination; 9) improving functioning of land markets; 10) consumer-driven public services. In addition it recommends reducing protectionism by rich-countries.

2. The Growth Report's lead author, economist Michael Spence, describes the Commission as an independent body of policymakers, business leaders and scholars. It includes two winners of the Nobel Prize in economics – Robert Solow and Spence. The Commission's work on the *Growth Report* was sponsored by the World Bank, the Australian Agency for International Development, Dutch Ministry of Foreign Affairs, Swedish International Development, Britain's DFID and the William and Flora Hewett Foundation.

3. Two trends making for rising inequality of incomes and demands for protectionism or other measures to protect jobs in industries affected by them are: increasingly rapid movement of economic activity from one location to another; and the impact of labor-saving technologies. They work to speed up economic growth, but pose a potential threat to some workers' jobs and job security particularly in information processing. Since protecting companies and job from international competition will slow economic progress, it is better to protect people and incomes, providing support to workers between jobs and preserving their access to essential services during these transitions. But there is a fiscal cost to providing such support which limits the amount and duration of support that can be considered.

4 The populations of some developing countries – net exporters of commodities whose prices have risen – benefit at least potentially from these rises to the extent they do not reverse themselves. But the World Bank estimates that some 100 million people may have been pushed into poverty because of high commodity prices of 2007 – 2008. Low-income countries are particularly vulnerable to the adverse effects of rising commodity prices to the extent they are net importers of the commodities whose prices have risen. The factors contributing to price increases include: rising demand, shifting diets, droughts in wheat exporting countries, increased costs of key agricultural inputs, and policies that encourage the use of agricultural land and output for bio-fuels.

The low agricultural prices that prevailed in international trade until recently bred a false sense of security among governments, leading them to neglect investments in rural infrastructure, research and development, storage, and food security programs. The UN, the World Bank and other multilateral agencies have mobilized efforts to deal with the immediate crisis by providing aid. While the initial multilateral response is encouraging, the crisis highlighted a lack of economic cooperation between countries. Many major food-exporting developing countries have reacted to the crisis by restricting exports to help contain prices at home (e.g., Thailand with rice). These steps exacerbate the supply shortage in the rest of the global economy. (The report's publication antedated the recent tendency of commodity prices to retreat, giving up some of their gains. But the discussion is relevant since it is likely that even after all adjustments haven taken place the relative prices of both food and fuels will stay higher than they were before 2007).

5. By mid-2007, international reserves held by central banks had increased enormously – to about $4.5 trillion, with China's reserves alone reaching approximately $1.6 trillion. In addition, the holdings of sovereign wealth funds, which are about $3 trillion, have increased because of high oil prices and governments' willingness, in search of a higher rate of return, to hold a more diversified portfolio of foreign assets. Thanks to financial innovation, the stock of financial assets – much of it in the form of derivative financial instruments, has grown three times faster than global GDP since 1980. Recent events are causing this increase in financial intermediation to reverse itself, posing great challenges to policymakers in central banks and ministries of finance around the world. Central banks' responsibilities have suddenly been increased beyond that of controlling inflation and have grown to encompass avoiding or dealing with credit crunches, financial panics, growth slowdowns, asset bubbles, and exchange rates. In the face of relatively free international capital flows, it is unclear whether central banks have enough instruments to accomplish these objectives